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## Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability

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# SEEKING SUNLIGHT IN SANTA FE'S SHADOW: THE SEC'S PURSUIT OF MANAGERIAL ACCOUNTABILITY

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## I. INTRODUCTION

Largely as a result of the explosive growth in the study of international and comparative capital marketplace law, scholars have given securities regulation an extraordinary amount of good press recently.<sup>1</sup> Bernie Black has drawn from this literature to conclude that a strong legal disclosure regime is a “core institution” required for broad-based stock ownership.<sup>2</sup> If one recalls that in the late 1960s and early 1970s many scholars derided the task of promoting corporate disclosure through law as either unnecessary or counterproductive, this turnabout is particularly remarkable.

This literature has another striking feature. Much of this scholarly applause for “transparency” comes because it is an effective strategy for promoting good corporate governance. Jack Coffee, for example, writes about the world-wide convergence of corporate law largely through the harmonization of disclosure requirements as a matter of securities law.<sup>3</sup> The insight here, as Louis Brandeis predicted, is that in most cultural and economic settings managers behave better in the glare of sunlight.<sup>4</sup> In this frame, mandatory disclosure and antifraud enforcement are part and parcel of the overarching effort to control agency costs. To be sure, these same truth-telling strategies have other crucial functions as well, particularly the more conventional goal of helping investors make prudent investment decisions by providing them with high quality information. These are not inconsistent

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1. See, e.g., Rafael LaPorta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Andrei Shleifer & Robert Vishey, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

2. Bernard S. Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1571 (2000). See also Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 808 (2001).

3. See John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641 (1999). See also Merritt Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROBS. 113 (1999).

4. Brandeis said “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY* 92 (1932).

goals, however. Corporate accountability via transparency is simply the current point of emphasis.

This revisionism is important because it speaks to one of the long-standing and most contentious issues in the history of American securities regulation: whether corporate and securities law should be seen as separate spheres, or whether instead they are part of a unitary enterprise that neither can nor should be divided. The former view invokes federalism as its code word and tries to confine the ability of securities regulation to participate liberally in setting standards of fiduciary responsibility. This is the idea that a plurality of the Supreme Court tried to express in *Santa Fe Industries, Inc. v. Green*,<sup>5</sup> for example. The latter view—bolstered by the current thinking—sees securities regulation largely as one of many forms of corporate law. This idea has an intellectual pedigree going back to William Cary, if not further.<sup>6</sup> Securities and corporate law have coordinate and complimentary jurisdiction over the control of agency costs in the public corporation, without much of substantial importance—or any strong reason—to delimit the power of either, so long as there is some connection to the duty of candor.

My aim in this paper is not to justify at length an expansive “new corporation law” perspective, though I do believe in it. Nor do I want to try to resolve a controversial question that the new learning admittedly leaves open: which jurisdictional body should set the disclosure and antifraud standards insofar as they are designed to promote better corporate governance? To say that corporate and securities law are largely unitary does not necessarily mean that centralization of authority in the Securities and Exchange Commission (SEC or Commission) is the right choice. Perhaps the states,<sup>7</sup> foreign countries,<sup>8</sup> or stock exchanges<sup>9</sup> would do better, justifying a narrow scope to federal securities law. I happen to favor centralization,<sup>10</sup> but will not seek to justify that preference here, either. Instead, I want to focus largely on the question of strategic behavior by the SEC. Assuming that the

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5. 430 U.S. 462 (1977).

6. See Arthur Fleischer, Jr., “Federal Corporation Law”: An Assessment, 78 HARV. L. REV. 1146, 1146 n.2 (1965); Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1 (1993).

7. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

8. See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998).

9. See Paul G. Mahoney, *The Allocation of Government Authority: The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999).

10. My views are similar to those expressed, for example, in James D. Cox, *Premises for Reforming the Regulation of Securities Offerings: An Essay*, 63 LAW & CONTEMP. PROBS. 11 (2000). See Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45 (2000).

Commission desires relatively free reign to pursue corporate accountability, how, within its current statutory authority, does it act in so doing? How can it best enlist the cooperation of other actors whose influence in this area is also important? In other words, how can it leverage its authority in order to maximize its influence, given whatever limitations in authority and resources might exist?

Initially, this inquiry will be into the state of the law. A conventional view—enshrined in *Santa Fe*, and later expressed vigorously in cases like *Panter v. Marshall Field & Co., Inc.*<sup>11</sup> and *Business Roundtable v. SEC*<sup>12</sup>—espouses that there is an important doctrinal line of demarcation between the spheres of corporate governance and securities regulation, one dealing with substantive regulation and the other with disclosure. Most significantly, these cases and their echoes in the contemporary case law suggest that “mere” breaches of fiduciary duty and corporate mismanagement are not properly something that securities law (and hence the SEC) should seek to remedy. This line of authority is invoked when the SEC tries to push hard in the governance area and at least potentially constrains the Commission.

Admittedly, *Santa Fe*’s reading of the securities laws states an important doctrinal principle. The SEC cannot adopt a federal version of a state corporation code or pursue breaches that are wholly without deception.<sup>13</sup> Aligned with many others in the “new corporation law” camp, however, I have long suspected that this line is conceptually (if not ideologically) overdrawn. There are not many instances of governance abuse that are disclosed with complete candor. Hidden breaches of fiduciary obligation can almost always be characterized in terms of fraud or misrepresentation.

Part II explores this battleground. If the SEC is to have the freedom to pursue managerial accountability, it needs the cooperation of the judiciary. The courts, essentially, have to be enlisted as the Commission’s agents in overcoming whatever formalistic distinctions appear in the law’s text. But *Santa Fe*, *Panter*, and *Business Roundtable* are highly salient symbols of resistance, rather than cooperation. Our first task, then, is to take a current inventory of how the federalism metaphor has played out in the courts. What does the word “mere” mean when we speak of fiduciary breaches and mismanagement allegations? Is there any principled justification for restraining a federally enforceable duty of candor with respect to fiduciary breaches?

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11. 646 F.2d 271 (7th Cir. 1981).

12. 905 F.2d 406 (D.C. Cir. 1990).

13. See *Santa Fe Industries v. Green*, 430 U.S. 462, 476 (1977).

The findings are decidedly mixed. The federalism metaphor lives and has force. However, I want to show that the metaphor is often just window dressing for what are really fairly standard decisions under the prevailing law relating to the “duty to disclose.” There is a strong basis for a disclosure duty in many recent skirmishes that represent important victories for a broad view of the federal role. This suggests that the inflated rhetoric one sees in the citations to *Santa Fe*, when there really is a more narrow basis on which the case could be decided, reflects more the ideological preference for weak securities law as it relates to corporate governance than a compelling doctrinal construct. While this sort of strict constructionism is not entirely without intellectual respectability,<sup>14</sup> it easily becomes a cover for rent-seeking by corporate managers simply wishing to expand or protect their autonomy, and the Commission should resist this practice without apology.

If the law, then, is no more than a mild constraint on the SEC, what else limits its ability to pursue corporate accountability aggressively? Part III starts from the premise that there are severe practical limitations on the tools and resources available to the Commission to enforce its authority. The enforcement staff is far too small, and the remedies available to the Commission are too confined to overcome deficiencies in detection and prosecution. The historically favored supplement, private securities litigation, is hobbled partly by its own internally generated costs and partly by legislative and judicial encumbrances. This part examines how the SEC tries to overcome these deterrence limitations. Most significantly, the Commission has focused more and more of its attention recently on gatekeeper strategies, seeking to enlist lawyers, directors, and especially accountants as its agents in the battle. While there is room to maneuver here, we should not be surprised by the extent to which predictable traits of human nature make deterrence by both insiders and gatekeepers more difficult than expected.

The primary message of Parts II and III is that the SEC must pursue the battle for compliance with corporate accountability standards on two distinct levels. One is direct lawmaking and law enforcement. This, as we have seen, is severely constrained by lack of resources and the resistance of human nature, if not by law. To compensate, the SEC must more carefully express the legitimacy of what it does in a way that makes both the courts and

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14. See sources *supra* notes 7-9. See generally Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995). As I read Mahoney and the others, they essentially agree that disclosure is a sound mechanism for controlling agency costs—indeed, it is the essential purpose of the regime of securities law—but doubt that the SEC is well-suited to perform this task efficiently. The common theme here is that the SEC is overly insulated from competition and hence becomes unresponsive to cost-benefit considerations.

significant actors, such as corporate officers and directors, accountants, and lawyers, more willing accomplices in the effort. As Part VI will show, this expressive task is not easy at all. Both the ideology and the self-interest of some actors rest on denigrating the legitimacy of the SEC's policing efforts. Moreover, the Commission may find itself in a conflicted situation: the kinds of expressive and rhetorical actions that help it gain political resources in the public realm may compromise its ability to gain cooperation and compliance within the regulated community. Regulation FD is an illustration of this.<sup>15</sup> This Article ends with some thoughts about building a more powerful "brand message" for securities regulation, tying this effort back to the new agency cost literature.

## II. *SANTA FE*'S SHADOW: TESTING THE FEDERALISM CONSTRAINT

### A. *SEC Rules*

SEC disclosure rules seek to promote corporate accountability in two ways. One is by forcing issuers to disclose their financial performance in accord with generally accepted accounting principles on a quarterly basis. Plainly, this motivates managers to achieve the kind of performance that pleases investors. While this discipline may have its downside—it may, for example, cause an obsession with short-term earnings to the exclusion of less readily measurable items of economic value, and tempt managers to skew the reported data in the form of fraud or "earnings management"—the prevailing view is highly supportive of this strategy.<sup>16</sup> *Santa Fe* has no plausible influence here. The SEC's authority under section 13(a) gives it free reign to implement whatever measures of financial performance it wishes.

The second mechanism to promote corporate accountability is by requiring disclosure of discrete events or other facts that shareholders would presumably consider important regarding the management of the company.<sup>17</sup> Part IV of Regulation S-K (and S-B for small business issuers) requires disclosure of a number of facts that touch on management's character, competence, and conflicting interests, such as pending litigation, executive compensation, self-dealing transactions, and so forth.<sup>18</sup> The compensation

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15. 17 C.F.R. § 243.100-103 (2000).

16. See generally Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1342 (1996).

17. On the scope of the SEC's rulemaking authority to determine how broadly investor (or other social) interests might extend, see Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

18. Management and Certain Security Holders, 17 C.F.R. § 229.400 (2000).

disclosure requirements of Item 402 reveal one place where the Commission has plainly tried to have an effect on primary behavior, with almost a “shaming” objective as compensation measures are displayed adjacent to performance results.<sup>19</sup> Whether this works is another question entirely; it has as likely fueled the upward spiral in salaries as operated as a check.<sup>20</sup> As discussed below, human nature responds differently to disclosure rules than we often predict.

Potentially, disclosure requirements relating to governance-facts are more of a federalist battleground, although the Commission’s authority to adopt disclosure rules in the corporate governance area has not yet been seriously challenged. Nonetheless, complaints are occasionally heard that the SEC is “overstepping” the dividing line between corporate and securities law when new initiatives are proposed. What is striking, however, is the relative shyness with which the Commission has approached rulemaking on the governance front. Quite plausibly, it could try to do far more than it has done to force the disclosure of matters touching on fiduciary responsibility, both in the general reporting obligations under section 13(a) and in connection with proxy solicitations under section 14(a). It also has largely unexplored definitional powers, both with respect to fraud under section 10(b)<sup>21</sup> and—in something that could be a potent intrusion into corporate governance matters—the question of what constitutes a reasonable system of internal controls under section 13(b)(2).

Precisely why the Commission hasn’t pursued a more aggressive accountability agenda is complicated. One reason, no doubt, is a lack of resources to police any expanded sphere of disclosure. As we shall pursue more fully in Part III, the Commission has too much to do, with too few resources. Disclosure is also an area of significant resistance from the business community, and the SEC may have other fights on which it would rather spend its scarce political capital.<sup>22</sup> Third, there is an historic preference for using enforcement actions generally to push its agenda, rather than

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19. Executive Compensation, 17 C.F.R. § 229.402 (2000).

20. See John Bizjak et al., *Has the Use of Peer Groups Contributed to Higher Levels of Executive Compensation?*, available at [http://papers.ssrn.com/paper.taf?abstract\\_id=252544](http://papers.ssrn.com/paper.taf?abstract_id=252544) (last visited May 17, 2001).

21. See Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority*, 107 HARV. L. REV. 963 (1994) (exploring rulemaking authority so as to limit private enforceability).

22. The SEC’s enforcement history under section 13(b)(2) is fairly clear in demonstrating the fear of provoking a reaction based on the claim of too great an incursion into corporate governance. See Exchange Act Release No. 17500, 21 SEC Docket 1466 (Jan. 29, 1981). For some of the criticism, see ABA Committee on Corporate Law and Accounting, *A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934*, 34 BUS. LAW. 307 (1978).

rulemaking. Finally, the Commission may have some doubts about its authority here, fearing that *Santa Fe* may be an implicit limitation on its ability to act. One purpose for the following discussion is to test whether the existing case law really supports this last constraint, or whether *Santa Fe*'s shadow is instead something of an optical illusion.

One other matter relating to rulemaking in the interest of accountability is worth mentioning here. As the recent flurry of activity over audit committees makes clear,<sup>23</sup> the Commission can move indirectly by prompting self-regulatory organizations (SROs) to act and thus cause substantive reforms that very much resemble state law forms of governance rules. *Business Roundtable* limits how much muscle the Commission can put behind this effort, but does not prevent the result if "voluntarily" accepted by the SROs.<sup>24</sup> Clearly, this route is important in the search for accountability.<sup>25</sup> My one note of caution looks to the future. Listing standards—the primary mechanism for these indirect governance initiatives—implicitly assume some level of centralized trading to be effective. If trading continues to fragment over the next few years, the SROs will find it increasingly uneconomical to implement, monitor, or enforce rigorous standards. This difficulty, in turn, will limit the Commission's ability to pursue this kind of tactic and force it toward other strategies.

### *B. Enforcement*

The more common way the Commission acts in the corporate governance area is via enforcement. This can be as simple as pursuing a straightforward violation of an existing reporting rule, in which case no federalism constraints are present. Often, however, the Commission moves in an area touching on corporate governance that is less clearly defined, opening up the possibility of argument about crossing the line into *Santa Fe*'s forbidden world. This is a subject that began in earnest with the SEC's administrative proceeding in *Franchard Corp.*,<sup>26</sup> continued through the management integrity and corrupt practices issues of the 1970s, and remains visible today

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23. See *Audit Committee Disclosure*, Exchange Act Release No. 42266, 71 SEC Docket 787 (Dec. 22, 1999). For a critical view, see John F. Olson, *How to Really Make Audit Committees More Effective*, 54 BUS. LAW. 1097 (1999).

24. See Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565 (1991).

25. See Helen S. Scott, *The SEC, the Audit Committee Rules and the Marketplaces: Corporate Governance and the Future*, 79 WASH. U. L.Q. 549 (2001).

26. 42 S.E.C. 163 (1964).



in such matters as the section 21(a) report in *W.R. Grace & Co.*<sup>27</sup>

There are a host of subissues raised by these kinds of cases. *W.R. Grace*, for example, is more interesting on the question of who was responsible for the failure to disclose a self-dealing transaction than whether there was a false filing in the first place. What is important for us is to push aside these kinds of distractions and assess the state of the law on the archetypal accountability question. When, if ever, is there a federal law duty to disclose information relating to a simple breach of fiduciary duty?

This is *Santa Fe*'s domain. After *Santa Fe*, some kind of misrepresentation or nondisclosure is an essential element of any claim brought under Rule 10b-5 or any other "fraud" provision of the securities laws, for that matter. An open and notorious breach of duty does not work.<sup>28</sup> But as noted earlier, there is probably only a small set of cases where all the relevant facts going to an alleged breach are set before the shareholders in an open and candid fashion. The temptation to conceal or "spin" is too strong. Hence, my hypothesis is that this is not a severe restriction in and of itself.

Related to this, however, is something less obvious and potentially more important. The law is clear that for any such case to go forward, the subject of the alleged nondisclosure must be the underlying facts from which the possibility of a breach may be inferred. With citation to *Santa Fe*, courts consistently say that corporate managers are not expected to characterize their actions in pejorative terms (self-accusations) or volunteer information about their subjective motivations.<sup>29</sup> Because motivation—especially bad faith—is a key aspect of fiduciary responsibility, this could be a significant limit embedded in the law. But again, I suspect not. Self-serving or other inappropriate motivations typically lead to consequences that are covered up or distorted. Sadly, some plaintiff lawyers are surprisingly persistent in styling their claims in a way that violates this black-letter law when they could easily do better, and suffer accordingly in front of impatient judges. Judicial decisions such as these convey the impression that *Santa Fe* is a powerful force, but this is misleading. The SEC is skilled enough to avoid falling into this somewhat obvious trap.

Assume, then, that a complaint properly alleges concealed facts. The ultimate *Santa Fe* question is whether there are any other policy-induced

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27. Exchange Act Release Nos. 39156-57, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,963 (Sept. 30, 1997).

28. In *United States v. O'Hagan*, 521 U.S. 642 (1997), the Court found the secret misappropriation of confidential information by a fiduciary to be a fraud in connection with the purchase or sale of a security.

29. E.g., *Lewis v. Chrysler Corp.*, 949 F.2d 644 (3d Cir. 1991); *Panther v. Marshall Field & Co.*, 646 F.2d 271, 287-89 (7th Cir. 1981); *Biesenbach v. Guenther*, 588 F.2d 400, 401-02 (3d Cir. 1978).

limitations that constrain the federal duty of candor. This question has arisen in settings involving the nondisclosure of illegality, breaches of the fiduciary duty of loyalty, and, to a far lesser extent, the duty of care. We shall proceed through these in order. We will then consider the hybrid problems of breaches of duty in merger and acquisition transactions and the issue of earnings management.

Before doing that, however, we should clear up a point that, unfortunately, has confused some courts, and perhaps thus added to the doctrinal muddle. Some courts have said that the securities laws should not concern themselves with the disclosure of misconduct because it would not further the goal of providing investors with information;<sup>30</sup> insiders willing to engage in the wrongdoing in the first place will simply ignore the disclosure obligation. But one of securities laws' functions is to offer a remedy for situations where investors have been injured by the absence of the truth, paying more than the securities were really worth in light of the hidden facts or casting votes without the benefit of accurate information. That kind of harm deserves redress whether or not the underlying rule succeeds in forcing disclosure.<sup>31</sup> Any potential overlap between the securities remedy and the state remedy may become relevant at the point at which a remedy must be chosen, but overlap is no cause for a per se dismissal of federal interest in the first place.

### 1. *Illegality*

We begin with a matter that has long fascinated scholars and practitioners: the nondisclosure of illegal corporate or managerial behavior. This has been explored exhaustively elsewhere, though less so recently.<sup>32</sup> My interest in the subject here is mainly to illuminate the general substance-disclosure conundrum.

Most all the academic attention has been on the question of the *materiality* of unlawful behavior. To speed through this well-worn subject, there is general agreement that unlawful conduct that, if discovered, poses a significant threat to the company's financial situation is material (so-called "quantitative materiality"). *Craftmatic Securities Litigation v. Kraftsow*<sup>33</sup> is a

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30. *E.g.*, *Ballan v. Wilfred Am. Educational Corp.*, 720 F. Supp. 241, 249 (E.D.N.Y. 1989).

31. Just as important, the distinct remedy operates as a form of additional deterrence, perhaps leading the actor to forego the improper activity.

32. For a collection of materials, see JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 106-15 (3d ed. 2001).

33. 890 F.2d 628 (3d Cir. 1989). *See also* *SEC v. Joseph Schlitz Brewing Co.*, 452 F. Supp. 824 (E.D. Wis. 1978).

useful example, where alleged violations of Federal Trade Commission (FTC) regulations were sufficiently extensive that discovery would alter the company's income stream.<sup>34</sup> The harder question, the so-called "qualitative materiality" debate, is whether smaller examples of illegal behavior, such as commercial bribes, sufficiently cast doubt on the integrity of key corporate actors and would thus also be important to the reasonable investor. Splitting, presumably, on the question of how bottom-line oriented the average investor really is, some courts have said yes as a general matter,<sup>35</sup> while others have said no, unless the impropriety cast doubt on the loyalty of the official to shareholder interests.<sup>36</sup> Under the latter view, a garden-variety bribe would not cast such doubt, because it was presumably done to make the shareholders richer.

Though this materiality issue is provocative, I have nothing to add. What is far more important for our purposes is the follow-up question: was there a violation of some disclosure duty in not revealing the misconduct, even if it was material? Courts sometimes confuse materiality and duty issues, sometimes in the direction of declaring something immaterial—even though shareholders would find it important—on grounds that it is not the sort of thing the issuer should have to disclose.<sup>37</sup> That should be the work of the "duty" analysis. Materiality should be the question of what the reasonable investor would likely find significant, nothing more, nothing less. However, it is also important to avoid the converse error: assuming a duty simply because materiality is present.

This point in the analysis is where the muddiness begins, and the muddiness is to some extent the Commission's responsibility. During the 1970s, in connection with the foreign bribery scandals, the SEC took an extraordinarily broad view of issuers' obligations to disclose corrupt practices, in a way that conflated the materiality and duty prongs.<sup>38</sup> This was

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34. *Id.* at 640.

35. See *Roeder v. Alpha Industries, Inc.*, 814 F.2d 22 (1st Cir. 1987). This disagreement is all part of the long-standing debate over "management integrity." For a disparate set of views on this history, see John M. Fedders, *Qualitative Materiality: The Birth, Struggles and Demise of an Unworkable Standard*, 48 CATH. U. L. REV. 41 (1998); Ralph C. Ferrara et al., *Disclosure of Information Bearing on Management Integrity and Competency*, 76 NW. U. L. REV. 555 (1981); Bevis Longstreth, *SEC Disclosure Policy Regarding Management Integrity*, 38 BUS. LAW. 1413 (1983); James D. Redwood, *Qualitative Materiality Under the SEC Proxy Rules and the Fifth Amendment: A Disclosure Accident Waiting to Happen or Two Ships Passing in the Night?*, 1992 WIS. L. REV. 315; Eric D. Roiter, *Illegal Corporate Practices and the Disclosure Requirements of the Federal Securities Laws*, 50 FORD. L. REV. 781 (1982).

36. See *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981).

37. See *Starkman v. Marathon Oil Co.*, 772 F.2d 231 (6th Cir. 1985).

38. See Exchange Act Release No. 12,946, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,783, at 87,031 (Nov. 2, 1976).

not entirely unreasonable, however, because at that time there was a fair case to be made that those two concepts were subject to conflation.<sup>39</sup> However, the law then turned. At least since *Chiarella v. United States*,<sup>40</sup> it is clear that no duty to disclose arises simply because a trader or issuer possesses material nonpublic information. There must be some separate basis for the duty, and only a limited number of possibilities seem to exist today for imposing one.<sup>41</sup>

Nothing in the mandatory disclosure rules compels comment on illegal behavior per se. Pending litigation and criminal proceedings may have to be disclosed, along with convictions and significant judgments.<sup>42</sup> However, uncharged crimes need not be disclosed. Given that, it is hard at first glance to see how the company or its officers could ever violate any disclosure obligation by remaining silent. Indeed, this is precisely the basis on which a number of well-known cases involving criminal prosecutions for nondisclosure of uncharged crimes have absolved the defendants of liability.<sup>43</sup> These cases, however, emphasize the criminal prosecution context, leaving open the possibility that the answer would be different in a civil case.

Some of the heavy lifting here is done by the half-truth doctrine,<sup>44</sup> codified for SEC filing purposes in Rules 408<sup>45</sup> and 12b-20.<sup>46</sup> Once a subject is addressed, whether in a filing or public statements, the speaker must add additional material information necessary to make statements made not misleading.<sup>47</sup> The question, then, becomes one of what sorts of statements

39. See Jeffrey D. Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979).

40. 445 U.S. 222 (1980).

41. See COX ET AL., *supra* note 32, at 749-54. As a general matter, the accepted duties to disclose under Rule 10b-5 are (1) when there is a fiduciary relationship, (2) when there is a duty to update or correct, or (3) when statements made operate as a half-truth. See generally Dale A. Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: Are We There Yet?*, 20 CARDOZO L. REV. 135 (1998). In addition, a few courts have suggested a "flexible duty" standard under which a duty can be implied even in the absence of any prior statement or fiduciary relationship. *E.g.*, *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1329-31 (8th Cir. 1991). The beginning of this line pre-dates *Chiarella* and may simply reflect some lower courts' unwillingness to reject the old case law. It also seems heavily bound up in theories of "secondary" liability (for example, aiding and abetting), now defunct after *Central Bank of Denver v. First Interstate Bank*, 511 U.S. 164 (1994). Most courts today at least implicitly reject the "flexible duty" approach by dismissing cases unless one of the more established duties can be found.

42. See Items 103 and 401(f) of Regulation S-K, 17 C.F.R. §§ 229.103, 229.401(f) (2000).

43. See *United States v. Matthews*, 787 F.2d 38 (2d Cir. 1986); *United States v. Crop Growers Corp.*, 954 F. Supp. 335 (D.D.C. 1997). These cases are to some extent driven by Fifth Amendment concerns. See Redwood, *supra* note 35.

44. See generally Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 STAN. L. REV. 87 (1999).

45. 17 C.F.R. § 230.408 (2000).

46. 17 C.F.R. § 240.12b-20 (2000).

47. 17 C.F.R. §§ 230.408, 240.12b-20.

touch closely enough on the illegality to make them technically true but misleading. On this, *Craftmatic* is illustrative.<sup>48</sup> The issuer placed great emphasis on its unique marketing structure in various disclosures, and the court found this description to be misleading without disclosing that these same marketing practices were in violation of FTC rules.<sup>49</sup> Another panel of the Court of Appeals for the Third Circuit conceptualized the half-truth duty by saying that improper practices must be disclosed because the issuer put the issue of legality “in play” by virtue of what it says, triggering an obligation of completeness.<sup>50</sup>

However, issuers seldom put matters of legality “in play” like that, and when properly applied, the half-truth doctrine is really very narrow. The interesting question, then, is how an issuer could ever have a duty to disclose the legality of its (or its managers’) behavior when there is no affirmative statement by the company that implies the absence of illegality. So far as the half-truth doctrine is concerned, at least, it seems quite a stretch to say that a duty to disclose illegal conduct by an officer is created simply because he or she has been identified as a company executive.<sup>51</sup> The challenge is to identify some particular statement in a 10-K or proxy statement that becomes false and misleading because information about the crime has been omitted. The Court of Appeals for the First Circuit, in *Roeder v. Alpha Industries*,<sup>52</sup> was one of the first courts to insist on finding some falsity even when the crime is material, and deserves credit for seeing what many other courts have not.

Once we take the duty question seriously, we run into hard questions. Exactly what portion of the narrative disclosure becomes false and misleading because of an undisclosed crime? For instance, it would take an overly broad view of the half-truth doctrine to say that an undisclosed embezzlement renders the management compensation table misleading.<sup>53</sup> Most intelligent readers understand the natural meaning of compensation,

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48. See *supra* note 33.

49. *Id.* at 640. See also *Ballan v. Upjohn Co.*, 814 F. Supp. 1375 (W.D. Mich. 1992); *In re Par Pharm. Inc. Sec. Litig.*, 733 F. Supp. 668 (S.D.N.Y. 1990).

50. *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 282 (3d Cir. 1992).

51. The question may be more interesting if the executive is described in glowing terms in the company’s publicity. Does this portrayal put the legality of his or her conduct “in play”? While this assertion is not implausible, it is worth noting that “puffery” tends not to trigger a duty to disclose contemporaneous negative information. See, e.g., *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 537-39 (3d Cir. 1999); *In re Mobile Media Sec. Litig.*, 28 F. Supp.2d 901, 938 (D.N.J. 1998); *In re Par Pharm. Sec. Litig.*, 733 F. Supp. 668, 678 (S.D.N.Y. 1990).

52. 814 F.2d 22, 28 (1st Cir. 1987).

53. But see *United States v. Fields*, 592 F.2d 638 (2d Cir. 1978) (treating unadjudicated section 16(b) liability as a debt to the corporation with respect to the line items requiring such disclosure in proxy statements). The stretching of the line item requirements to create a duty to disclose is observed in *Ferrara et al.*, *supra* note 35.

and it does not include ill-gotten gains. Finding the half-truth is all the harder when the crime is not self-serving. And this legal problem is not limited to the juicy qualitative materiality questions. Duty can be problematic with respect to quantitative materiality as well. Suppose that a material portion of a company's income is tainted by its association with commercial bribery. It is still income. The response, typically, is that this current financial performance is put at risk by the possibility that the illegality will be detected and the profits recouped or foreclosed in the future by some restraint on the business. But this kind of concern is conventionally one for the footnotes to the financial statements (contingent liabilities) or the Management Discussion & Analysis, which is limited in terms of matters "likely" to come to pass. While a few decisions properly take the analysis through these sorts of questions,<sup>54</sup> others still decide the case one way or another based largely on the materiality of what was concealed.<sup>55</sup>

My point here is a simple one. The doctrinal question of whether illegality must be disclosed often becomes difficult when we get to the duty prong. Courts that insist on such disclosure are implicitly either stretching the half-truth doctrine to force exposure of something because of its perceived materiality, or assuming some other basis for the duty to disclose. In the next subsection, we will consider another "duty" possibility—fiduciary obligation—that actually works well in many instances, and which goes a long way toward explaining the illegality cases in which violations of Rule 10b-5 or Rule 14a-9 are found. For now, let us at least put on the table the possibility that what courts are doing when they refuse to compel disclosure of illegal conduct is simply recognizing that the affirmative duty to disclose is generally quite limited under the federal securities laws. With that in mind, we shall move on to a related subject, where this issue explicitly confronts the rhetoric of *Santa Fe*.

## 2. Breaches of Loyalty and Conflicts of Interest

By far, the most important question relating to corporate accountability has to do with self-interested, but not otherwise illegal, behavior by corporate officials. In essence, this is what the agency cost problem is all about, and the new corporate governance literature says that disclosure plays an important

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54. See *United States v. Fehn*, 97 F.3d 1276, 1290-91 (9th Cir. 1996), for a good example of a court doing this. The difficult question here, even under a simple materiality emphasis, is predicting the probability that the illegality would be detected as of the time of the alleged omission, and then balancing that against the magnitude of the impact.

55. E.g., *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650 (2d Cir. 1979); *Shields v. Erikson*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,723 (N.D. Ill. Aug. 24, 1989).

role in deterring it. Does it follow, then, that failure to disclose information relating to fiduciary breaches involving the duty of loyalty are actionable *per se*? Based on what we learned in the previous subsection, no. The inquiry has to address both materiality and duty. With respect to materiality, the analysis is usually easy. If the executive is key enough, hidden conflicts and selfish behavior are important to the reasonable investor. This issue was the focus in *Franchard*. As such, materiality is rarely as difficult as it was in the illegality context, where the battle is fought over the line between selfish and nonselfish acts.

Duty, once again, is harder. Fortunately, Item 404 of Regulation S-K, reincorporated into the proxy statement instructions, creates an unambiguous obligation to disclose self-dealing transactions, the most obvious kind of loyalty issue.<sup>56</sup> However, agency cost theorists would quickly point out that Item 404 hardly exhausts the universe. The usurpation of corporate opportunities, misappropriation of corporate property, and unfair competition are examples of other forms of managerial opportunism in the day-to-day corporate world.<sup>57</sup> When these are at issue, or when the nondisclosure of traditional self-dealing arises in the contexts not involving SEC filings, we have to work harder to find a disclosure obligation.

This is where *Santa Fe* comes into play in an interesting fashion, and it is worth revisiting its history before coming back to the agency cost problem directly.<sup>58</sup> The case itself dealt with the “going private” phenomenon, and the question of whether inadequate value offered to shareholders was actionable for that reason alone. The Court’s answer was no, there must be deception. We know from the now lengthy subsequent history of that phenomenon, however, that some kind of concealment is commonplace in going private transactions that are truly opportunistic. Indeed, the SEC quickly intervened on this particular issue by mandating disclosure in Rule 13e-3 that makes it all but impossible to execute an unfair freeze-out without violating a federal disclosure requirement.<sup>59</sup> Thus, *Santa Fe* is no longer directly of much interest in going private deals.

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56. Certain Relationships and Related Transactions, 17 C.F.R. § 229.404 (2000).

57. An issue that has gathered much attention along these lines is the disclosure of corporate charitable contributions, under circumstances where the charitable institution may be affiliated with an insider. See Faith Stevelman Kahn, *Pandora’s Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579 (1997).

58. For some of the “prehistory” here, see James D. Cox, *Fraud is in the Eyes of the Beholder: Rule 10b-5’s Application to Acts of Corporate Mismanagement*, 47 N.Y.U. L. REV. 674 (1972).

59. See Ralph C. Ferrara & Marc I. Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263, 272-73 n.49 (1980). The judiciary has been fairly cooperative in enforcing this federalization. *E.g.*, *Howing Co. v. Nationwide Corp.*, 826 F.2d 1470 (6th Cir. 1987).

A subsequent use to which *Santa Fe* was put is the situation posed by the famous case of *Goldberg v. Meridor*.<sup>60</sup> Suppose company insiders engineer a purchase or sale of securities where they stand on one side, the company on the other. Assuming that allegedly unfair terms were concealed from the shareholders, is there any cause of action under Rule 10b-5? *Goldberg* said yes, the shareholders were deceived out of their ability to pursue a derivative action remedying the apparent breach of duty. Other courts, especially in the Court of Appeals for the Seventh Circuit, have said no, rejecting the notion that lost state law remedies are ever within the ambit of the federal securities laws,<sup>61</sup> clearly a *Santa Fe*-driven insight. But we should understand this issue carefully, for it deals with the very narrow question of whether: (1) it is meaningful to say that the fictional personage of the corporation is deceived whenever its insiders cause a purchase or sale of securities on concealed unfair terms<sup>62</sup> and (2) if so, whether nontrading shareholders have a right to bring suit for the nondisclosure based on a loss of state remedies. This question is perplexing not simply because of concerns about federalism, but because a line of precedent under Rule 10b-5 insists that private plaintiffs be actual purchasers or sellers of securities.<sup>63</sup> The precedent introduces a distraction on which *Santa Fe* may have something to say, but is complicated even in the absence of any federalism concerns. It would be a much more straightforward matter if purchasers of the company's stock (or the SEC) were the ones bringing suit based on an insufficiently or completely undisclosed purchase of stock by insiders. There, they would be alleging

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60. 567 F.2d 209 (2d Cir. 1977). For a more recent endorsement, see *Estate of Soler v. Rodriguez*, 63 F.3d 45 (1st Cir. 1995).

61. See *Harris Trust & Sav. Bank v. Ellis*, 810 F.2d 700, 704 (7th Cir. 1987). Short of outright rejection of the "right to sue" possibility, many courts have struggled toward a middle ground by permitting the suit in theory, but being strict about how clear it has to be that a breach occurred or that a remedy would be granted. See *Field v. Trump*, 850 F.2d 938, 947-50 (2d Cir. 1988). In the proxy area, this question has arisen in situations where proxies are solicited by the shareholders who lack the votes to block the majority's will. See *Virginia Bankshares Inc. v. Sandberg*, 501 U.S. 1083 (1991); *Scattergood v. Perleman*, 945 F.2d 618 (3d Cir. 1991).

62. The conceptual difficulty was well put many years ago by litigator Vernon Patrick, who wrote, "[I]t is as difficult to conceive of a corporation being 'deceived' as to imagine a corporation being in love." Vernon Patrick, *Rule 10b-5, Equitable Fraud and Schoebaum v. Firstbrook: Another Step in the Continuing Development of Federal Corporation Law*, 21 ALA. L. REV. 457, 469 (1969).

63. My sense is that *Goldberg* is right, and that the emphasis on lost state law remedies is really a distraction. The legal question should simply be whether the corporation was deceived when the insiders engineered the transaction after breaching their duty of loyalty. This question requires resort to agency law principles, but that is not unusual for federal securities litigation. If it makes sense to say that there was deceit practiced on the corporation, then it is a simple and conventional matter to let the shareholders sue derivatively. The Supreme Court's insider trading discussion in *United States v. O'Hagan* offers assistance to the claim of fraud on a corporation from the hidden selfishness of its insiders. 521 U.S. 642 (1997).



what is clearly an investment-related injury. The only questions should then be materiality and the duty to disclose.<sup>64</sup>

Putting *Goldberg* aside, the more basic question asks under what circumstances can the SEC or trading shareholders bring suit when insiders breach their duty of loyalty in some fashion (which may or may not involve trading in securities), and the facts are not fully disclosed? This question is the *Santa Fe* issue that is of most interest to the Commission, and courts have treated it explicitly as a difficult federalism problem. Rather unhelpfully, for example, one court has described the test after *Santa Fe* in the following terms: "Where the incremental value of disclosure is solely to place potential investors on notice that management is culpable of a breach of faith or incompetence, the failure to disclose does not violate the securities acts."<sup>65</sup> To make this inquiry more specific, suppose the chief executive officer of a company secretly sets up a controlled, family-owned firm that takes an opportunity within the company's line of business. The argument for a securities law violation is fairly straightforward. If management integrity means anything, this kind of breach surely is material.

At least one court<sup>66</sup> has cited *Santa Fe* for the proposition that a usurpation of corporate opportunity need not be disclosed because it belongs in the "corporate law" side of the legal divide.<sup>67</sup> This suggests that federalism is indeed a trump card, barring claims that otherwise have all the elements of a good cause of action. But note something about the facts of the case: nothing that the company or its officer said in any filing or voluntary disclosure put the corporate opportunity question "in play," and there was no shareholder involvement in the decision that required a proxy statement. Dismissal of the case could thus separately be justified on the grounds that there was no duty to speak to the shareholders, eliminating the need for any invocation of *Santa Fe*.<sup>68</sup>

While this is a plausible application of the law, there are many other cases that do impose disclosure obligations regarding potential managerial misconduct, without identifying any half-truth. Some of these involve crimes,<sup>69</sup> others noncriminal (but usually self-serving) misconduct.<sup>70</sup> Perhaps

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64. From the SEC's perspective, the matter is made easier by the fact that disclosure of the terms and conditions are required in the company's periodic filing. Were there any concealed facts there, the enforcement action would be straightforward.

65. *Craftmatic*, 890 F.2d at 640.

66. *Ciro Inc. v. Gold*, 816 F. Supp. 253 (D. Del. 1993).

67. *Id.* at 262-64.

68. Being a derivative suit, *Ciro* falls into the lost state remedies category, making it slightly off-point. See *supra* text accompanying notes 60-62.

69. See *supra* note 55.

the most important illustration of this is the fairly consistent body of case law forcing disclosure of hidden conflicts of interest in proxy cases. If lack of duty is such a serious bar to so many claims, how do these courts find it?

Unfortunately, most pay little attention to the issue. One of the leading cases on disclosure of conflicts of interests in shareholder voting decisions, *Kas v. Financial General Bankshares, Inc.*,<sup>71</sup> contains a thoughtful discussion of the *Santa Fe* question in holding that nondisclosed facts relating to a conflict of interest transaction are subject to a duty of disclosure, thereby giving a narrow reading to the Supreme Court's decision.<sup>72</sup> But on the question of why there is a duty in the first place, the court simply assumes it, citing authority back to *Mills v. Electric Auto-Lite*<sup>73</sup> on the need for disclosure of conflicts of interest because of their importance to shareholder-voters. But that assumption is the sort of materiality-duty conflation that became bad law in 1980.<sup>74</sup>

Perhaps *Kas* simply missed the duty issue, drawing on a pre-*Chiarella* line of authority without noticing the law's shift.<sup>75</sup> If so, it is wrong. But I don't think it is. The difference is that proxy cases are unique. Often, to be sure, the duty to disclose breach-related facts is discernable directly from the proxy disclosure rules. Item 5 of the instructions to Schedule 14A requires disclosure of the direct or indirect interests of officers and directors in the matter to be acted upon.<sup>76</sup> However, *Kas* doesn't point to Item 5 as a basis for the duty, and seems to be assuming something broader. Perhaps the court was thinking of the half-truth doctrine.<sup>77</sup> It is not easy, however, to argue that what is said in a proxy solicitation—that these people are officers and directors and they recommend the transaction—is misleading for failure to

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70. See *Maldonado v. Flynn*, 597 F.2d 789, 796 (2d Cir. 1979). A similar line involves disclosure of pending civil proceedings against managers. See *Zell v. InterCapital Income Sec. Inc.*, 675 F.2d 1041 (9th Cir. 1982). These cases, of course, can raise hard materiality issues. See, e.g., *GAF Corp. v. Heyman*, 724 F.2d 727 (2d Cir. 1983). In the criminal proceeding context, Item 401 creates a reasonably broad line item disclosure duty. See *United States v. Yeaman*, 194 F.3d 442 (3d Cir. 1999).

71. 796 F.2d 508 (D.C. Cir. 1986).

72. *Id.* at 513-14.

73. 396 U.S. 375 (1970).

74. See *supra* note 40 and accompanying text.

75. For a case that imposes no disclosure obligation with respect to a conflict and that might be reflecting such reasoning, see *Mendell v. Greenberg*, 938 F.2d 1528 (2d Cir. 1990) (en banc). *Mendell* seems to suggest that one has to attack the bona fides of the directors' recommendation as opposed to trying to force disclosure of conflicts. This case is hard to reconcile with the bulk of the case law in this area.

76. 17 C.F.R. § 240.14a-101, Item 5 (2000). Some courts have construed this fairly broadly. *E.g.*, *SEC v. Kalvex, Inc.*, 425 F. Supp. 310, 314-15 (S.D.N.Y. 1975).

77. Cf. *Credit Suisse First Boston Corp. Sec. Litig.*, [1998 Transfer Binder Supp.] Fed. Sec. L. Rep. (CCH) ¶ 90,306 (S.D.N.Y. Oct. 19, 1998) (using half-truth doctrine to impose duty to disclose conflicts in broker-dealer case).

disclose a skeleton in the closet. Realistically, these cases involve complete omissions, not partial misstatements.

To find a more broadly based duty to disclose in proxy cases, we need only to look to the most fundamental of grounds, emphasized by the Supreme Court in *Chiarella*:<sup>78</sup> the fiduciary obligation. Fiduciaries have an affirmative duty to disclose all material information in their possession when “dealing” with the beneficiaries of that trust.<sup>79</sup> Clearly, the rule applies when an insider is buying or selling securities, whether from the corporation or in the marketplace. No reference to the half-truth doctrine is needed then. And it is a small and logical step to extend this to situations where the insiders initiate a transaction that requires shareholder approval: for example, any fundamental corporate change, so long as shareholder votes are an “essential link” in the process. State law, from which courts borrow conceptions of fiduciary duty for federal disclosure purposes, is clear about management’s fiduciary duty of candor when seeking shareholder consent.<sup>80</sup> And this includes the election of directors.<sup>81</sup>

If all this is right, courts are correct in finding an affirmative disclosure obligation relating to such matters as internal misconduct and criminal activity in proxy cases, simply upon a showing of materiality.<sup>82</sup> The Court of Appeals for the Second Circuit’s otherwise perplexing dicta in *Maldonado v.*

78. 445 U.S. 222 (1980).

79. *Id.*

80. See, e.g., *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977); *Stroud v. Grace*, 606 A.2d 75 (Del. 1992). For a discussion, see Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director’s Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996).

81. See *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135 (Del. 1997). Interestingly, although recognizing the fiduciary obligation of disclosure in the election of directors context, *Loudon* then goes on to absolve the directors from liability with respect to allegedly material nondisclosures. *Id.* at 142-43. See also *Wolf v. Assaf*, No. 15339, 1998 WL 326662 (Del. Ch. June 16, 1998). This reasoning should be understood in the context of the state-law nature of the claim. Plaintiffs, by and large, were seeking monetary damages, and the court was clearly uncomfortable with this kind of derivative “candor” claim as a substitute for addressing the misconduct directly. Persuasive or not, this distinction is not relevant to the very different interests at stake in a federal securities claim. Put another way, the result in *Loudon* would be hard to justify were plaintiffs simply challenging the election itself. For further discussion, see 1 RODMAN WARD, JR. ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 212.4 (4th ed. 1999).

82. There are courts that have refused to compel disclosure of self-serving misconduct, even in proxy cases. E.g., *In re Browning-Ferris Indus. Inc. S’holder Derivative Litig.*, 830 F. Supp. 361 (S.D. Tex. 1993). My sense is that these cases are wrongly decided, though given the confusion in the law, the courts should not be blamed too harshly. This might also explain the line of authority begun by *United States v. Matthews*, which rejects a criminal prosecution based on failure to disclose a crime in a proxy solicitation. 787 F.2d 38 (2d Cir. 1986). *Matthews* and its progeny explicitly distinguish the criminal from the civil contexts, implying (correctly, in my view) that such a duty might arise in a civil case. See *Matthews*, 787 F.2d at 47. The separate criminal treatment might be justified on Fifth Amendment or lenity grounds.

*Flynn*<sup>83</sup> that the proxy rules only set a “minimum” for required disclosure becomes justifiable. It is also right to impose a fiduciary duty when insiders are buying or selling shares under Rule 10b-5 and the 1933 Act liability provisions.<sup>84</sup> This imposition includes both open market purchases and issuer transactions; thus, *Franchard*, imposing a broad duty to disclose conflicts in a registration statement notwithstanding no obvious line-item requirement, is justifiable on this basis.<sup>85</sup> A key insider benefits from the sale of shares by the issuer, and hence is “dealing” with at least potential shareholders in initiating a solicitation.<sup>86</sup>

On the other hand, this fiduciary duty of disclosure does not apply when the insiders are not dealing with shareholders in either of these ways. Absent some kind of transactional nexus involving the insider, courts are clear under both federal and state law<sup>87</sup> that there is no fiduciary duty of candor on an ongoing basis. There is no duty to apprise even trading shareholders of all material information simply to rescue them from an ill-advised decision, much less apprise nontrading shareholders of garden-variety misconduct so that they can seek to remedy it. The law can be rationalized, then, without any reference to federalism principles, by saying that when an insider or issuer is not transacting in shares or seeking shareholders’ votes, a duty to disclose arises only if there really was a half-truth. That is, management in nonproxy cases has to make statements that truly are misleading before it has a duty to reveal the facts relating to a possible fiduciary breach.

This approach reconciles the case law fairly nicely, if not perfectly. Most interestingly, it leaves the SEC nearly unlimited freedom to pursue undisclosed fiduciary breaches. The Commission can bring cases under Rule 14a-9 and bootstrap the fiduciary duty of disclosure when the line item instructions do not suffice. The *Franchard* theory remains viable in the 1933 Act context because of the sale to investors that is involved.<sup>88</sup> Outside of the “dealing with shareholders” setting, however, the Commission must be more careful to articulate a duty, and should rewrite Part IV of Regulation S-K if it wants issuers and managers to address a subject more extensively than a

83. 597 F.2d 789, 796 (2d Cir. 1979). This also helps make sense out of *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650 (2d Cir. 1979).

84. See *Shell Petroleum Inc. v. Smith*, 606 A.2d 112 (Del. 1992) (short-form merger).

85. 42 S.E.C. 163 (1964).

86. The Supreme Court in *Chiarella* was fairly clear that the fiduciary obligation of disclosure is owed to investors who by the transaction become shareholders of the corporation. 445 U.S. 222 (1980).

87. See *Malone v. Brincat*, 722 A.2d 5 (Del. 1998).

88. In the context of a private placement, see *United States v. Peterson*, 101 F.3d 375 (5th Cir. 1996).

natural reading of the instructions would permit. In other words, the filing of a 10-K or 10-Q should not alone trigger a fiduciary-based duty to disclose all material information relating to managerial breaches of the duty of loyalty. The half-truth doctrine becomes the only plausible recourse in those kinds of cases.

### 3. *Care*

A fair number of securities law cases try to bootstrap breach of duty of care claims, presumably to avoid the business judgment rule and procedural roadblocks under state law. Often citing *Santa Fe*, courts are strongly disposed to dismiss these. One obvious barrier in a Rule 10b-5 case is scienter: negligence cases are not cognizable under that Rule, and negligence is the typical claim in a duty of care setting. This place is also where plaintiffs often get tripped up making “self-accusation” claims.

However, opportunities for artful pleading are not entirely foreclosed by these limitations, at least when a duty to disclose can be located. Take, for example, a case like *Smith v. Van Gorkom*,<sup>89</sup> the best known of Delaware’s duty of care cases. The self-accusation/motivation problem could be avoided by claiming not that the board failed to disclose its own foolishness, but that the board failed to disclose particular facts that would lead a reasonable shareholder to infer the foregone opportunities to seek a better price. Indeed, the Delaware Supreme Court found that the company’s disclosures were not candid. Scienter could be shown insofar as the disregard rose to the level of subjective recklessness (something indistinct from the Delaware court’s finding of “gross procedural negligence”). Yet one is hard pressed to identify a significant case ever won by plaintiffs on these sorts of grounds under Rule 10b-5.

In cases where shareholder votes are solicited for a particular proposal, as in *Van Gorkom*, Rule 14a-9 makes a duty of care claim even easier. Most courts, presently at least, seem to accept negligence as the proper state of mind standard.<sup>90</sup> Problems relating to “who can sue” are largely resolved in plaintiffs’ favor by liberal reliance standards.<sup>91</sup> If the shareholder vote, moreover, is an essential link in the transaction, “transaction” causation is (or at least should not be) a problem. Hence it should be possible to plead such

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89. 488 A.2d 858 (Del. 1985). The case I am imagining is one brought by trading shareholders, rather than preexisting ones.

90. *E.g.*, *Herskowitz v. Nutri/System Inc.*, 857 F.2d 179, 189-90 (3d Cir. 1988); *Gould v. Am.-Hawaiian S.S. Co.*, 535 F.2d 761, 777-78 (3d Cir. 1976).

91. *See Stahl v. Gibraltar Fin. Corp.*, 967 F.2d 335 (9th Cir. 1992); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

cases successfully. Yet, even here it is hard to find examples of successful claims by plaintiffs where the allegations go simply to breaches of care.

A familiar subcategory of duty of care cases involves failures of oversight, by negligence or deliberate disinterest. This subcategory was part of *Franchard*, where even the SEC backed off of insisting on any form of director self-accusation (though it did not excuse the failure to disclose the underlying facts, which dealt with the duty of loyalty by a controlling shareholder).<sup>92</sup> There has been a fair amount of litigation since then where plaintiffs accuse directors of failing to uncover some kind of wrongdoing by others. The hook for federal jurisdiction is typically that these directors stood for re-election without disclosure of their nonfeasance. Again, these cases almost always fail,<sup>93</sup> though often the reason relates to loss causation (a matter not of interest in SEC actions): there is no showing of proximate cause between the election and any loss to the shareholders.<sup>94</sup>

*Santa Fe* has had a great influence in this setting. Courts have not wanted to create too easy an end run around the business judgment rule. But it would be a mistake to assume that the SEC's hands are tied completely as a result. The best way to test this would be to pose the problem in terms of a classic state law allegation of a breach of the duty to monitor. A good example would be a case such as *In re Caremark International Inc. Derivative Litigation*,<sup>95</sup> which involved director nondiscovery of illegal activities regarding fraudulent Medicare and other claims. We should be clear, of course, that an action by the SEC against the company would raise different (and usually not terribly difficult) issues. As we have seen, nondisclosure of pervasive illegality is material, and often in breach of some duty. Our question here is simply whether the directors themselves could be implicated for their nonfeasance, which would indeed go to a crucial question in the world of corporate accountability. The SEC's position in the *W.R. Grace* action was that knowing toleration by a director of an apparently misleading disclosure is actionable, though the Commission did not bother to say on what grounds and seemed to take pains to avoid litigating the issue, even in-house.<sup>96</sup> Here, we are dealing with the harder problem of negligence or inattention.

We need to distinguish between two litigation options. One, as in

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92. 42 S.E.C. 163 (1964).

93. *E.g.*, *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1364-65 (N.D. Tex. 1979).

94. *See General Elec. Co. v. Cathcart*, 980 F.2d 927 (3d Cir. 1992).

95. 698 A.2d 959 (Del. Ch. 1996). There were indeed federal securities lawsuits arising out of these facts. *E.g.*, *Isquith v. Caremark Int'l, Inc.*, 136 F.3d 531 (7th Cir. 1998).

96. *See supra* note 27.

*Franchard*, is saying that there was nondisclosure of the fact of (or facts underlying) the inattention. This option stretches the law, although it is not entirely implausible to say, for example, that a reasonable investor deciding how to vote would find important that persons they elected did nothing when faced with a specific set of described facts.<sup>97</sup> If nondisclosure of a criminal misconduct could be a violation in this context, it is hard to see, conceptually, why nondisclosure of a fairly egregious example of ignoring red flags could not be. But again, there is little case law to support this.

That, however, is not terribly important, because there is a simpler way to go. The SEC, at least, can simply charge the negligent director with participation in the company's breach. There are a number of routes that are open. Section 17(a) of the Securities Act permits SEC actions based on negligence.<sup>98</sup> Remedially, a cease and desist order could be issued without a showing of scienter so long as the director could be said to have "caused" the violation. The key, as in *Grace*, is articulating a duty. Those directors who signed the filing that omitted the key information might well be said to be primarily involved, and there is now case law support for such a view.<sup>99</sup> In the absence of a signature, there would have to be an even stronger articulation of the view that a director's role in disclosure involves a fairly intense duty of inquiry—a right to rely on other corporate officials, modified by a need to assure that they are doing their jobs in a well-designed reporting environment. This approach would nicely federalize the *Caremark* issue, assuming the materiality of the misconduct elsewhere within the corporation. While such requirement would no doubt provoke a *Santa Fe*-type protest of undue incursion into corporate governance, it is hard to see that the specific elements of a solid securities law claim would be lacking. It would be that much easier if the SEC could tie the nonfeasance to an absence of a reasonable internal accounting control system.

Thus, there is legal room to expand the pursuit of accountability notwithstanding the hostility that courts have shown in private class or derivative actions. Having said this, however, I should make clear that I would tread gently here for pragmatic reasons.<sup>100</sup> One of the great difficulties

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97. Perhaps somewhat analogous is *McMahan & Co. v. Warehouse Entertainment, Inc.*, 900 F.2d 576 (2d Cir. 1990), where the court found a misrepresentation when outside directors were described as independent without disclosure of the fact that they consistently voted in support of management.

98. See *Aaron v. SEC*, 446 U.S. 680 (1980). The SEC might also charge the director as a controlling person under section 20(a). Some courts insist on recklessness or some sort of "culpable participation" in the wrongdoing, however.

99. See *Howard v. Everex Systems, Inc.*, 228 F.3d 1057 (9th Cir. 2000).

100. This point is made more fully in Donald C. Langevoort, *The Human Nature of Corporate*

with respect to director oversight responsibility is that, in the abstract, we can define all sorts of things that directors should pay more attention to. As legal exposure grows with respect to particular items, the resulting anxiety is likely to crowd out other, perhaps more, useful activities that directors perform. Moreover, a piling up of legally imposed responsibilities runs the risk of undermining the legitimacy of the laws' demands, making them appear thoughtless and unfair. This effect, in turn, may actually reduce compliance in the absence of a high threat of enforcement. In sum, in this area norms and other nonlegal influences should do most of the work. The Commission could act more aggressively in pursuit of corporate accountability in promoting the duty of care, but probably should not.

#### 4. *Mergers and Acquisitions*

The foregoing discussion of fiduciary breaches—and the importance of distinguishing clearly between materiality and duty issues—helps clarify some interesting case law in the mergers and acquisitions area, where *Santa Fe* is also frequently cited. Quite simply, in negotiated transactions where shareholder approval is necessary, there should be (and the case law is fairly consistent in demanding) a duty for the initiating management to disclose all material information, without regard to specific instructions or the half-truth doctrine. *Santa Fe* should have no influence so long as the nondisclosure claim is sufficiently factual, rather than demanding a legal conclusion.<sup>101</sup> A harder question, but a very narrow one, is what the consequences are if shareholder votes are not necessary. This question resembles the issue in *Goldberg*, and will no doubt split the courts along the same lines. *Santa Fe* could plausibly be invoked to support either conclusion.<sup>102</sup>

A very recent case from the Second Circuit, *Minzer v. Keegan*,<sup>103</sup> nicely illustrates the impotence of *Santa Fe*-reasoning in this context. The issuer and another company, both banking institutions, agreed to a merger. While the negotiations were on-going, a third party expressed a serious interest in doing the deal instead, at a better price. It was rebuffed, and allegedly never (unlike the preferred party) given an opportunity to do the due diligence

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*Boards: Law, Norms and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001).

101. Thus, for example, the stringent insistence on disclosures of all conflicts of interest. See *TSC Indus. v. Northway*, 426 U.S. 438 (1976); *Mills v. Electric Auto-Lite Co.*, 390 U.S. 375 (1970).

102. See *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987 (2d Cir. 1988); *supra* notes 60-62.

103. 218 F.3d 144 (2d Cir. 2000), *cert. denied*, 121 S. Ct. 1190 (2001). In the interest of full disclosure, I should say that I assisted counsel for the plaintiffs in unsuccessfully seeking a writ of certiorari in *Minzer*.



required to make a firm bid significantly above the price being offered by the other. Plaintiffs, who brought a case under Rule 14a-9, alleged that the reason for the lack of interest was that the first party had committed to lucrative employment contracts for the issuer's senior management, while the new bidder made clear that it would not do the same. What we have, then, is a classic case of management allegedly placing its thumb on the scales to favor a bidder in a takeover battle based on its own self-interest.

Yet clearly, it is also properly brought in federal court, *Santa Fe* notwithstanding, so long as the facts about the third party's interest were material and nondisclosed or (as plaintiffs claimed here) actually misrepresented.<sup>104</sup> Materiality seems clear, for it goes both to a conflict of interest and the possibility that the company was worth more than the favored bidder was offering.

What is interesting is that Judge Winter is troubled by this outcome; he cites *Santa Fe* out of frustration, making clear that he would rather this be a state law case.<sup>105</sup> Yet he does not affirm the district court's dismissal on materiality because, one suspects, he saw that this was properly pleaded as a truth-telling case in a setting where shareholders are owed full disclosure, even though it was also about a classic allegation of lack of managerial accountability to shareholder interests. Judge Winter does affirm, however, on the strange grounds that rational shareholders would have voted to accept management's allegedly inferior proposal even if told the truth.<sup>106</sup> Shareholders would have felt incapable of forcing management to pursue the better deal. Thus, even if there was a violation of Rule 14a-9, "transaction causation" was lacking. Judge Winter failed to appreciate the inconsistency of this holding with *Mills v. Electric Auto-Lite Co.*,<sup>107</sup> which rejects exactly this kind of "shareholders would have voted for it anyway" objection. That he was forced to engage in it in the first place, it seems, is ample testimony to the fragility of *Santa Fe* in the face of a well-pleaded complaint.

In hostile takeover battles, on the other hand, the scope of the disclosure duty is much narrower. At least in all-cash deals, there is no fiduciary relationship running from the bidder to the target shareholders. In addition, the target company is not trading with its shareholders or seeking their consent. Thus, the scope of affirmative disclosure obligations imposed by

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104. The proxy statement stated that the third party "withdrew" from the bidding, omitting that it did so only when rebuffed from being given the opportunity for due diligence that had been given to the other side.

105. *Id.* at 151.

106. *Id.* at 152.

107. 396 U.S. 375 (1970).

sections 14(d) and (e) and Rule 10b-5 is narrower: the parties must make their required disclosures and must refrain from lying or telling half truths in what they do say. However, there is no liability for remaining silent regarding some alleged breach, unless and until the subject of the breach is “in play” so as to trigger the half-truth doctrine. One of the strongest endorsements of the federalism principle, *Panter v. Marshall Field & Co.*,<sup>108</sup> is filled with ideological rhetoric, but, read carefully, need not stand for much more than this. This point is reinforced by noting that if the incumbent managers actually lie to trading investors about their motivations in taking some action, that lie will (and should) be actionable under section 14(e) or Rule 10b-5.<sup>109</sup>

### 5. Financial Fraud and Earnings Management

An important subject, to which we shall return in the next Part, is whether corporate managers are under excessive pressure to manage earnings, leading them to make inappropriate or overly aggressive accounting judgments fit the financial figures (especially earnings) within Wall Street’s expectations. Recent work is abundant that details the incentive structure and rewards of so doing, reinforcing the perception that this is indeed a serious issue.<sup>110</sup>

At first glance, it is hard to see a *Santa Fe* type issue here when fraud is alleged, for we are dealing with the heart of financial disclosure. But *Santa Fe*’s echoes are discernable on issues such as SAB 99,<sup>111</sup> which expands the definition of materiality to extend to quantitatively immaterial shadings that are done to move the company’s numbers onto target or just above, rather than slightly below. From an agency cost perspective, this expansion is rightly within the jurisdiction of the SEC. Accounting data is performance data, and investors are entitled to use it to set whatever performance benchmarks they wish. Shading goes directly to managerial accountability. Management has put the issue in play, thereby bringing with it the issue of integrity. In sum, as the Second Circuit recently said in *Ganino v. Citizens*

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108. 646 F.2d 271 (7th Cir. 1981).

109. See *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236 (3d Cir. 1989); *Fry v. Trump*, 681 F. Supp. 252 (D.N.J. 1988).

110. E.g., Francois Degeorge et al., *Earnings Management to Exceed Thresholds*, 72 J. BUS. 1 (1999) (market expectations); Ron Kasznik, *On the Association Between Voluntary Disclosure and Earnings Management*, 37 J. ACCT. RES. 57 (1999) (market expectations); Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83 (2000) (compensation effects).

111. Staff Accounting Bulletin No. 99, 7 Fed. Sec. L. Rep. (CCH) ¶ 75,563, at 64,087 (Aug. 12, 1999).

*Utilities Co.*,<sup>112</sup> shading readily satisfies both the materiality and duty prongs of any securities law claim.

Another recent case that indirectly offers support for a broad “management integrity” scope to the duty to disclose truthful financial information is *AUSA Life Insurance Co. v. Ernst & Young*.<sup>113</sup> AUSA purchased notes from a company, JWP, and, pursuant to the purchase agreement, received financial statements certified by Ernst & Young. The statements were false, although not in ways that at the time affected JWP’s cash flow (the matter of interest to the debtholders). Instead, the falsifications were directed mainly at the company’s equity investors, for they had a material impact on reported earnings.<sup>114</sup> The ensuing case did not question either duty or materiality: they were both present. Rather, the issue was causation (in this case, unlike *Minzer*,<sup>115</sup> “loss causation”).<sup>116</sup> JWP became insolvent after making a disastrous acquisition, which occurred after the debtholders had invested and was not itself concealed.<sup>117</sup> In a fascinating dissent, Judge Winter observed that one way the financials were material to the noteholders, so that they were deceived in a meaningful way, is that the falsifications created extra pressure for management to avoid subsequent discovery, which would most readily be done by engaging in high risk actions such as the acquisition in question. Thus, he found loss causation.<sup>118</sup> His opinion is an insightful recognition of the ways in which disclosure seamlessly becomes a basis, ex ante, for addressing agency cost problems.

### C. Summary

We can summarize all of the foregoing along the following lines. The factual elements underlying a breach of fiduciary duty have to be disclosed under the federal securities laws, *Santa Fe* notwithstanding, when they are:

- (a) material; and
- (b) (1) required by a line-item instruction;
- (2) necessary to make a statement by or on behalf of the issuer not misleading; or

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112. 228 F.3d 154 (2d Cir. 2000).

113. 206 F.3d 202 (2d Cir. 2000).

114. *Id.* at 204-07.

115. 218 F.3d 144 (2d Cir. 2000).

116. *AUSA*, 206 F.3d at 207.

117. *Id.* at 206.

118. *Id.* at 229-31.

- (3) related to a transaction in which the corporation or its shareholders are owed a fiduciary duty of candor.

While the limitations built into this structure (for example, the absence of a general duty of candor even in the absence of transacting with shareholders) might be justified on federalism-type principles, they need not be. This structure derives logically from principles underlying the affirmative duty to disclose that has evolved under the securities laws without conscious reference to such principles.

This idea is an important point in terms of the SEC's interests. In essence, *Santa Fe* is invoked as a restraint mainly in those cases in which it is superfluous. The law is reasonably consistent then that when a duty to disclose otherwise exists, there is no federalism bar raised by the fact that the subject matter is a fiduciary breach, so long as it is material and styled in terms of undisclosed facts rather than motivation or legal conclusion. That said, because the SEC has so much rulemaking control over the duty issue, its freedom to operate in this area is extremely broad.

*Santa Fe's* shadow, therefore, is much more an ideological projection than a doctrinal reality. The courts that continue to espouse it are doing so in dicta because they want a world of weak federal corporate law. If the Commission is afraid of the shadow, it should not be. The new learning on corporate accountability implies a greater role for disclosure rules as a means of constraining fiduciary misconduct. If the Commission proves that it can carry out this mission efficiently, there is little merit to the claim that its hands should be tied.

### III. OTHER LIMITS ON THE SEC'S EFFECTIVENESS: RESOURCES AND HUMAN NATURE

The foregoing study of the SEC's authority to pursue breaches of fiduciary duty indicates that there are surprisingly few limits on the reach of the Commission. In other words, the securities laws should operate as a strong deterrent to hidden breaches of duty, especially those involving some form of self-dealing. Further, given the relative historic success of the U.S. capital markets, we should not be overly concerned about the current state of affairs. We should also keep in mind the strength of the nonlegal forces: reputation, norms and culture, and product market incentives that motivate managers to act in a manner reasonably consonant with the desires of their shareholders.<sup>119</sup> Nonetheless, there is a persistent (and probably realistic) fear

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119. See Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253

that agency costs continue to be problematic in U.S.-based corporations, and leads us to two questions. First, why might our disclosure regime, in connection with the concurrent system of state corporate law and nonlegal incentives, be less than fully effective in controlling agency costs? Second, and more importantly, how might the SEC act strategically to improve the situation? Here, we move from questions of doctrine to questions of implementation.

*A. Limited Resources and Limited Remedies*

The obvious starting point, perhaps an answer in and of itself to any perceived deterrence deficiency, is the SEC's lack of enforcement resources. Enforcement personnel are spread thin not only among investigations and actions involving managerial accountability, but numerous other matters, such as the conduct of the securities industry and its associated persons. The numbers are only part of the story. SEC enforcement lawyers are underpaid, leading to high rates of turnover. This high rate of turnover, in turn, means a loss of experience and expertise, a large burden given the resources and talent typically on the other side of an important enforcement matter. The consequence is far fewer investigations and enforcement actions than optimal, and a pressure to settle rather than take a case through an expensive trial, meaning that the terms of settlement sometimes end up being fairly generous to the defendants. In a rational world, at least, this underenforcement is not lost on the managerial community. This problem is so overwhelming that it is difficult to say something meaningful about it other than the obvious; the Commission deserves far more resources than it has.

Further, the remedies available to the Commission when it brings a case do not have enough of a deterrence element built in. While the SEC can get disgorgement of gains made possible by a breach of candor, it is less clear that this kind of relief will be granted when the breach occurs after the fact (such as, a failure to disclose the transaction in a 10-K). Civil penalties have helped, but it would take more than the current scale to create a measure appropriate to compensate for the likely underdetection of offenses. Pursuing large penalties, especially against the natural persons who caused the violations, also tends to provoke a vigorous defense, running counter to the desire to achieve high levels of settlement. Nor have the courts been particularly helpful. For example, with respect to the officer and director bar

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(1999); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001).

authority that Congress granted the SEC in 1990, one can readily assume that any CEO who deliberately engineers a significant securities fraud deserves for that reason alone (absent some strong shareholder-oriented justification) to be removed from his job. However, the courts have superimposed additional requirements that make such an order far more difficult to obtain.<sup>120</sup> What would have been a strong threat becomes more muted.

The SEC, of course, has lacked resources and remedies since its inception. Thus it has developed a set of techniques by which it tries to leverage what it has. One of these is to try to create an inflated impression of the threat of action. This leveraging is no doubt part of the tendency to bring many cases and settle most, rather than concentrate on fewer and fight harder. The Commission also tries to find cases with good publicity value: well-known defendants, intriguing facts, and the like. Well-publicized enforcement actions can be highly salient, and the investing public and business community may overestimate their frequency as a result. Settling or bringing a case as an administrative proceeding also reduces the risk of a publicized loss in court, something that the SEC seems to fear greatly.

The Commission has an agent besides the press through which to seek a magnification of its message: the legal profession. I have written fairly extensively about this and do not wish to repeat myself.<sup>121</sup> However, it seems clear that the self-interest of the securities bar calls for fairly powerful securities regulation and enforcement. Though on the surface they act as clients' advocates for less agency power (for example, taking conservative positions on matters such as *Santa Fe's* influence), their preference, I suspect, would be for the courts not to prune federal (or state) legal authority too much. The scarier the legal threat, the more their services are needed and the more influence they have over their clients. The savvy securities lawyer (or groups acting in concert) will inflate the threat of Commission action at the same time that he, she, or they complain about it. As I have suggested elsewhere, this process does not necessarily involve any deliberate form of bias. Human nature, as will be discussed more fully below, has a remarkable ability to lead people to believe that which is in their interest to believe. A good example of threat magnification is the *W.R. Grace* proceeding, noted earlier.<sup>122</sup> This proceeding was a settled action without any remedy, where

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120. See *SEC v. Patel*, 61 F.3d 137 (2d Cir. 1995) (insisting on a showing of likelihood of repetition).

121. See Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997); Langevoort, *supra* note 100.

122. See *supra* note 27.

the directors in question clearly knew of an omission in a 10-K, though they might have had an excuse for not pursuing it. In this “cheap” setting, the Commission offered some fairly broad thoughts about the corporate governance responsibilities of outside directors to monitor the company’s disclosure compliance, at least as it relates to SEC filings.<sup>123</sup> When one reads the resulting trade press commentary (for instance, *New York Law Journal*, *Legal Times*), the dramatic portrayal of the Commission’s hostile “incursion” into corporate governance is fairly striking.<sup>124</sup>

Whether the managerial community really becomes more frightened as a result of this message sharpening is not entirely clear: maybe they are savvy enough to discount some or all of what their lawyers tell them. I suspect that some discounting goes on, but it is not enough to compensate: especially when lawyers act in concert to “agree” about an inflated characterization of the law. While we cannot measure the extent of the inflation, I suspect that there is some, though nowhere near enough to create a level of fear that offsets the reality of underenforcement.

### *B. Private Securities Litigation*

The conventional line in securities regulation is that private securities litigation is a necessary complement to the SEC’s deterrence efforts, in addition to serving a compensatory function. The plaintiffs’ bar is a natural ally to the Commission, and one that the Commission historically has faithfully supported.

For better or worse, there are doctrinal limits on how much work the private bar can do to remedy breaches of fiduciary duty, quite apart from the impact of *Santa Fe*. The “in connection with” requirement and the doctrine of loss causation, for example, make it very unlikely that the harm to the corporation will be remedied even when there was some undisclosed breach.<sup>125</sup> The point on which I want to focus, however, is broader.

Over the last three decades, with increasing intensity, the plaintiffs’ securities bar has come under attack as engaging in self-serving behaviors—particularly, the filing of weak cases for their settlement value—that are inconsistent with the investor-protection goals of securities regulation.<sup>126</sup> This “tarring” of the plaintiffs’ bar has been immensely successful. It led

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123. *Id.*

124. E.g., Bruce A. Hiler & Ira H. Raphaelson, *When Reasonable Reliance Isn’t Enough: The Evolving Standards for Board Oversight*, *INSIGHTS*, Jan. 1998, at 2.

125. See *supra* notes 60-62.

126. From among the many statements along this line, see Grundfest, *supra* note 21.

Congress to make significant (and probably excessive) reforms in both the process and substance of private securities litigation in 1995. Perhaps even more powerfully, it has influenced the courts. One cannot read the case law under Rule 10b-5 since 1975 without a palpable sense that lawmaking has been driven by a fear of speculative litigation that had to be deterred, even at the price of making good cases harder to bring. Sometimes the fear has been explicit, as in cases like *Blue Chip Stamps*<sup>127</sup> and *Central Bank of Denver*.<sup>128</sup> Sometimes it is more hidden, as in *Gustafson*.<sup>129</sup> Most potently, perhaps, has been its influence in the development of entirely new (or reinvented) doctrines under the securities laws. I doubt that we would have the three developments that to me, constitute the most interesting substantive change in 10b-5 doctrine over the past fifteen years—the “bespeaks caution” doctrine,<sup>130</sup> the reinvigoration of an extraordinarily powerful “mere puffery” defense,<sup>131</sup> or the stunning willingness of judges to decide difficult materiality issues “as a matter of law”—were it not for the intensity of this perception.

It would be venturing too far from the purposes of this Article to explore how justified or unjustified this perception has been or to estimate what effect the reforms have had on the deterrence calculus. My beliefs are (1) that the fear is partly justified but significantly overstated and (2) that the reforms, such as the new pleading standard, have done some damage, but have not been debilitating, much less fatal.<sup>132</sup>

The question for us is the role of the SEC. Plainly, the Commission has suffered from the perception of abuse, and not simply by the cut-back in the power of an ally. In the courts, it has to deal with doctrines like puffery and bespeaks caution. It is also finding courts using the pre-Reform Act version of the “strong inference” pleading standard for securities fraud in SEC enforcement cases,<sup>133</sup> another doctrinal invention induced by hostility to private actions.

At the risk of judging too much by hindsight, the SEC came much too late

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127. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

128. *Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

129. *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995).

130. See Donald C. Langevoort, *Disclosures That “Bespeak Caution,”* 49 BUS. LAW. 481 (1994).

131. See Jennifer O’Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697 (1998).

132. See Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639 (1996). For an analysis that shares this same perspective, see Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567 (2000).

133. Compare *SEC v. Cassano*, 61 F. Supp.2d 31 (S.D.N.Y. 1999), with *SEC v. Drescher*, [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶90,681 (S.D.N.Y. Oct. 19, 1999).



to the acknowledgement that the incentive structure of private securities litigation is such that abuses are indeed plausible, if overstated, and some reforms justifiable. Understandably, it stuck by its ally. But that ally was losing a battle in both perceptual and real terms, and the Commission could perhaps have both protected investor interests better and headed off the excessive reaction of Congress and the courts had it taken more initiative in the design and endorsement of sensible monitoring devices. In terms of message, it needed to make clear to the courts especially, that their “dis-ease” was legitimate but needed to be treated in ways that were proportionate and did not infect the entirety of the regulatory apparatus. By not doing this, the Commission allowed those ideologically opposed to strong securities law to associate the abuses of private litigation with the enterprise of securities regulation as a whole.<sup>134</sup>

That is water over the dam, however. What should the Commission be doing today, in the aftermath of excessive pruning? Limited resources make this difficult, but the Commission should spend some time and effort assuring at least that no further damage is done. Most pointedly, it must pursue a message that, possible abuses notwithstanding, there are many good cases that are at risk post-reform.<sup>135</sup> The best way to do this is to open a handful of investigations in cases where private actions have been dismissed, or are on the verge of dismissal. Public exposure of these instances should be emphasized when they demonstrate the merit of the plaintiffs’ claims. At the same time, however, the Commission should be candid if it determines after investigation that a case truly was based on little more than speculation—if not quite so vigorous in the publicity effort.

### *C. Human Nature: The Problem of Earnings Management*

The deficiencies we see in the compliance structure are due primarily to insufficient detection and penalty. The law, on the other hand, is quite workable. However, we should not assume too easily that the law is all there is to the challenge of reducing agency costs via a cluster of disclosure-oriented strategies. We may have neglected an element of the less-than-wholly-rational side of human nature, an element to which the SEC has historically paid little attention. Many interesting insights can be drawn from

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134. For some insightful thoughts on the rhetoric of securities law reform and its impact on the business of securities regulation, see James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3 (1999).

135. See Elliott J. Weiss & Janet E. Moser, *Enter Yossarian: How to Resolve the Procedural Catch-22 That the Private Securities Litigation Reform Act Creates*, 76 WASH. U. L.Q. 457 (1998).

the persistent problems relating to earnings management.

### *1. Managerial Behavior*

A subject that has fascinated scholars (including me) is why an insider would ever risk anything less than candor with the capital marketplace.<sup>136</sup> Even if successful for a time, misrepresentations are usually exposed. Given how much the market cares about accurate information, there should be a significant penalty to the reputation, and hence earning power, of the responsible persons, not to mention the risk of legal exposure. The issuer, into which the executive may well have sunk a fair amount of human capital, may also be penalized by the markets when it loses credibility.

There is a rational response that is partially persuasive. Under some circumstances, the short-term gain to the insiders is worth whatever risk of reputational penalty. Extremely high options grants may make it tempting to manipulate earnings, no matter the consequences.<sup>137</sup> More significant, perhaps, is the so-called “last period” problem. Executives who fear being fired for inadequate performance—and the resulting damage to their reputations from that event, may face a positive pay-off from strategies that cover-up the deficiencies, even if they are eventually discovered. At least they will have had their jobs that much longer, and maybe luck would bail them out in the meantime. The tougher outside directors become in monitoring performance using objective benchmarks, the more likely it is for insiders to commit fraud.

This kind of rational decision making can be countered only by increasing either the adverse consequences that come from discovery or the likelihood of detection. Here, of course, we return to the problem of resources. It is worth asking, however, whether there might be other forces that contribute to a decision to shade or manipulate accounting data, such as compliance decision making, that are less easy to explain rationally and may not be quite so easy to deter even with increased resources. Why, moreover, is the threat of moral sanction not a more potent force here? While the truth-telling norm may be slipping in strength in today’s society, it is not entirely absent.

One possibility arises from biases in perception. A financial officer faced with highly discretionary judgment calls is more likely to believe that those

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136. See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691; Mitu Gulati, *When Corporate Managers Fear a Good Thing is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675 (1999); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997).

137. See, e.g., Yablon & Hill, *supra* note 110, at 85-86.

decisions leading to a more positive presentation are realistic than a more neutral outsider would. Why? There are a host of psychological properties at work here, but they cluster under the heading of self-serving inference. We tend to justify, even internally, choices that are in our interest. This effect is magnified by optimism, which can be organizationally “conditioned”.<sup>138</sup> A positive image of the company’s skills and prospects will bias choices on such matters as loan loss reserves, customer returns, contingent liabilities, and so on. A comparable image of projects in which the company has invested will lead to judgments about useful life and other discretionary matters that are different from what a more jaundiced view might suggest. What is important here is that the views are held in good faith, with no sense of any manipulation (and hence no guilt).

This portrayal captures some of the bias, but not all. Some judgments plainly go over the line and will be recognizable, even to the person in question, as violating generally accepted accounting principles (GAAP). But even here, there are strong psychological pressures that lead decent people to cut corners without any feeling of guilt, thereby compromising the force of any social and moral norms. Again, optimism plays an important role. The judgment that the business will prosper with enough time and money, so that investors will eventually be thankful, provides an easy moral rationalization for short-term falsifications.<sup>139</sup> This force is compounded by something that cognitive psychologists call the sunk cost trap, a form of cognitive dissonance.<sup>140</sup> Little by little, financial executives make good faith, but overly optimistic, reporting judgments. These accumulate, and some turn of events creates the risk that they will be held accountable. The mental response is not recognition of the mistake followed by regret, but rather an increasingly unrealistic revisionism to justify those choices as ones a reasonable person would make. The consequence may well be further pursuit of the ill-advised course of reporting judgments, instead of a halt with admission of error. Again, until the point at which no alternative explanation is plausible, the person resists feeling that he has done something wrong. Many of the recently celebrated “cooked-books” allegations (Cendant, Microstrategy) could be told by reference to these sorts of cognitive and emotional forces, far better than any story of outright moral corruption. Certain personality types, such as narcissists, are particularly given to this

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138. See Langevoort, *supra* note 136, at 115-19.

139. See David M. Messick & Max H. Bazerman, *Ethical Leadership and the Psychology of Decision Making*, SLOAN MGT. REV., Winter 1996, at 9, 20.

140. See, e.g., Barry M. Staw, *The Escalation of Commitment to a Course of Action*, 6 ACAD. MGT. REV. 577, 578 (1981).

sort of thinking, and they frequently come to inhabit high corporate offices.<sup>141</sup>

Unfortunately, this kind of account plays into the deterrence calculus. People who do not recognize that what they are doing is unreasonable do not perceive the risk of illegality, even if the threat of detection and punishment exists. Even when there is some appreciation that one's conduct might overstep the rules, there is evidence that compliance decisions are heavily influenced by a person's biased comparison of the legitimacy of what they are doing vis-à-vis the moral force of the exogenous legal requirement, unless the risk of detection and punishment is very high.<sup>142</sup> That risk in securities law most assuredly is not high, and rationalization can lead to violations without substantial guilt.

## 2. *Market Behavior*

The behavioral traits of corporate managers are not the only unexpected influences on the problem of earnings management. Managers are plainly responding to the market and its obsession with meeting or beating analyst expectations. That the market rewards "meets or beats" and harshly penalizes anything short is fairly well-established, especially for growth firms.<sup>143</sup> We should thus try to understand why it is that short-term numbers, so notoriously the product of manipulation, provoke such behavior.

This question, of course, puts us back into the long-standing debate over market efficiency. While rational explanations are possible, an ever increasing amount of work points to persistent inefficiencies. Work in behavioral finance tries to explain these sorts of things in a way that can be tested empirically. One possibility that has been widely explored, for example, is that many investors (including some professionals) use only easily recognizable figures, like estimated and reported earnings, as bases for investment. These are simplifying strategies, and if widely enough used, lead to a "herding" in terms of expectations.<sup>144</sup> As soon as some negative news is released, however, the herd—limited in the depth of research and thus

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141. See Michael Maccoby, *Narcissistic Leaders*, HARV. BUS. REV., Jan.-Feb. 2000, at 69.

142. See generally TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990); Tom R. Tyler & Gregory Mitchell, *Legitimacy and the Empowerment of Discretionary Legal Authority: The United States Supreme Court and Abortion Rights*, 43 DUKE L.J. 703 (1994).

143. See, e.g., DeGeorge et al., *supra* note 110, at 5-8.

144. For a good discussion, see Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141 (1997). See also D. Eric Hirst & Patrick E. Hopkins, *Comprehensive Income Reporting and Analysts' Valuation Judgments*, 36 J. ACCT. RES. 47 (1998).

lacking confidence in their positions—simply turns in the other direction.

Another, somewhat related, account focuses on momentum.<sup>145</sup> While initial reactions to good or bad news may be fairly rational, any trading shift, especially in lesser-known growth firms, brings in a group of followers, such as, those who trade simply because of the trend, betting on its continuation. These traders may be following the market itself, as day-traders do, or reacting to the overenthusiasm in media or brokerage reports. Whatever the trigger, the follow-up trading creates a self-fulfilling prophecy, moving the price further along and thus for a time confirming the suspicions of the unsophisticated that their investment choices were wise. A surprising jolt of bad news, however, pops the bubble, causing an excessive reversal.

We could go further with possible explanations, but need not. The question that has puzzled theorists is not whether these sorts of behaviors are plausible, but why they are not offset by arbitrage activities on the part of the truly sophisticated. Here, again, theories abound. One is that arbitrage is too risky: the smart money does not know when the reversal will take place. Another is that truly smart money may actually want to provoke these kinds of bubbles, or at least play along for a time, so long as they feel nimble enough to exit before the crowd.<sup>146</sup> Especially if those playing this strategy are overconfident, one can readily see how their influence will make the bubble grow, not restrain it.

What is the significance of this to the SEC?<sup>147</sup> Putting aside the meta-issue of the value of mandatory disclosure in a highly emotional trading environment, we can make a far more simple point. If managers believe that markets depart systematically from rationality, overreacting to short-falls from earnings estimates, it becomes that much easier to justify to oneself and associates a program of earnings manipulation. A fortiori, if the perception grows to include manipulative conspiracies (e.g., short-sellers). Indeed, managers may systematically come to disbelieve in market efficiency as it relates to their stock's price in part not so much because such belief is well-grounded, but because it creates that much more psychological freedom to engage in self-interested or self-protective behavior. In this sense, there is a link between perceptions of the market and undercompliance with the securities laws.<sup>148</sup>

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145. See, e.g., Harrison Hong & Jeremy C. Stein, *A Unified Theory of Underreaction, Momentum Trading, and Overreaction in Asset Markets*, 54 J. FIN. 2143 (1999).

146. See J. Bradford De Long et al., *Positive Feedback Investment Strategies and Destabilizing Rational Speculation*, 45 J. FIN. 379 (1990).

147. See Robert B. Thompson, *Securities Regulation in an Electronic Age: The Impact of Cognitive Psychology*, 75 WASH. U. L.Q. 779 (1997).

148. For an interesting perspective on the motivations to manipulate accounting data, see Thomas

### 3. *Gatekeepers*

The SEC has long recognized the limits on its ability to deter securities fraud directly, even if it may not have had a perfect sense of why those limits are so powerful. This understanding is why the Commission has tried for so long to enlist the cooperation of third parties who have influence over corporate insiders to help deter securities fraud. This approach is the well-known gatekeeper strategy,<sup>149</sup> and with respect to on-going corporate disclosure, the primary gatekeepers are accountants, lawyers, and outside directors. The Commission increased its efforts to have each of these groups play a more active monitoring role over insider-generated disclosure, mainly by threatening liability consequences against those who fall short.<sup>150</sup>

I have written elsewhere in some depth about this kind of strategy as it relates to predictable traits of human nature in both lawyers<sup>151</sup> and outside directors.<sup>152</sup> I am unpersuaded that stepped-up liability threats are wise or productive except where the outsiders are actually complicit in the fraud. Here, briefly, I want to turn to the accountants who audit corporate financial statements, especially as it relates to the on-going debate over auditor independence.

Accountants should be good gatekeepers. They are well-trained professionals with fairly strong reputational incentives to perform well in the auditing task. They also face heavy legal exposure. While the audit function can hardly be expected to expose all fraud, it should operate as a powerful check on managerial overreaching in a number of settings. This strength aside, where is the potential deficiency in auditors' performance?

A standard answer is lack of independence, something addressable by definitional rulemaking of the sort recently completed by the SEC.<sup>153</sup> Nonaudit sources of income from the firm being audited can surely alter the mix of financial incentives that accountants face. Without doubting the relevance of this, however, I suspect that the real source of pressure on

Lys & Margaret Neale, *Relative Reality*, CHIEF EXEC., Dec. 1996, at 72.

149. See Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. ECON. & ORG. 53 (1986); Frank Partnoy, *Barbarians at the Gate?: A Proposal for a Modified Strict Liability Regime*, 79 WASH U. L.Q. 491 (2001).

150. Both the audit committee rules, *supra* note 23, and the *W.R. Grace* proceeding, *supra* note 27, are illustrations of this strategy in operation.

151. See Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75 (1993).

152. See Langevoort, *supra* note 100.

153. See *Revision of the Commission's Auditor Independence Requirements*, Exchange Act Release No. 43,602, [2000-01 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,406, at 83, 989 (Nov. 15, 2000).

auditors is subconscious and derives from two sources. One, on which the SEC heard testimony during its auditor independence hearings, is self-serving inference.<sup>154</sup> Auditors are hired by management, normally, and interact closely with them. Their preference is to please the managers, which can bias judgment in close-call situations. The other is the commitment bias, and grows from the first: once judgments are made that are biased toward management, probably quite innocently, a strong pressure arises to justify those choices in the face of new information that calls into doubt the wisdom of the prior decisions. Slowly, and without conscious realization, the auditor becomes co-opted into the pattern of decision and loses the ability to resist.

Neither of these kinds of biases is unusual in business settings, and the solutions are fairly obvious.<sup>155</sup> Self-serving inference is dealt with by altering the chain in command; auditors should be hired and monitored by the audit committee of the board. Commitment biases are dealt with by rotation of personnel and intensive peer review, though this can be quite expensive. While each has been the subject of regulatory attention, the SEC and its allies in the accounting profession have stopped short of demanding them. This lack of action may be politically wise for the SEC because such issues, if pushed to their logical conclusion, would probably dwarf the “nonaudit fee” issue in controversy while nevertheless leaving in place a natural limit on the ability of the audit to be an effective restraint on managerial opportunism.

#### IV. CONCLUSION: THE POLITICAL AND EXPRESSIVE FUNCTIONS OF THE SEC

We can bundle all of the foregoing together by saying this: The securities laws do provide a potentially powerful mechanism for controlling agency costs. However, limited resources, in terms of the SEC’s ability to investigate and enforce, and deficiencies in the ancillary system of private enforcement, some systemic and others imposed by the judiciary and Congress, limit the effectiveness of this form of control. Furthermore, predictable features of human nature frustrate some of the deterrence strategies that the Commission

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154. See Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597 (2000). For a comprehensive analysis of biases that auditors might fall prey to, see Robert Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000). See also Max H. Bazerman et al., *The Impossibility of Auditor Independence*, SLOAN MGT. REV., Summer 1997, at 89; Mark W. Nelson & William R. Kenney, Jr., *The Effect of Ambiguity on Loss Contingency Reporting Judgments*, 72 ACCT. REV. 257 (1997).

155. See Chip Heath et al., *Cognitive Repairs: How Organizational Practices Can Compensate for Individual Shortcomings*, 20 RES. ORG. BEHAV. 1 (1998).

tries to implement.

These limitations mean that the SEC has to fight its battles through more than rulemaking and enforcement actions. In this conclusion, we need to think about the expressive nature of what the Commission does—influencing key constituencies by the expression of ideas, through persuasion as distinct from compulsion. The more politically savvy SEC chairmen, commissioners, and staff appreciate this expressive function, though they may have defined it too narrowly. That is the dilemma with which I want to end this Article. The primary political mission of the SEC is to gain resources. Given the current dearth of resources, that mission should not be denigrated. The primary giver of resources is Congress. In this sense, the Commission's political task is most obviously a search for popular and/or institutional support that can lead key members of Congress to want to favor stronger rather than weaker securities regulation.

The brand image it has utilized, more clearly under Arthur Levitt than any recent chairman, is that of the “investor's champion.” That is, close alliance with the interests of individual investors, and the inculcation that there are serious battles within the world of investing at which the “little guy” is at a fatal disadvantage without powerful federal help. Given the tilt in the preference toward individual vis-à-vis intermediated investing in the 1990s (a trend that may or may not continue), that emphasis seems fairly savvy.

The message is communicated in many ways. Some are direct, such as web sites, investor town meetings and education, speeches, and rulemaking initiatives, all accompanied with aggressive publicity. Others are more subtle. I have written elsewhere that the campaign against insider trading is the quintessential form of advertising designed to reinforce the underlying brand message: it offers highly resonant and compelling images (greed and hubris) and demands behavior that people love to insist on in others (restraint and fiduciary responsibility).<sup>156</sup> It is to the SEC what the Clydesdale beer wagon is to Budweiser and probably has helped the Commission gain a supranormal level of public support and more resources than it would have otherwise. The “investor's champion” brand message is also effective with another key constituency, the SEC's own staff. It is a motivator and a source of internal cohesion for what is widely regarded as a first-rate governmental agency.

Over the past decade, the Commission has been “on message” fairly consistently. Regulation FD probably was the rhetorical high point,<sup>157</sup> but

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156. See Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319 (1999).

157. See *Selective Disclosure and Insider Trading*, Exchange Act Release No. 43,154, 65 C.F.R. 51,175 (Aug. 15, 2000).



there have been many others. One of the more subtle themes of the 1990s was the Commission's fight against the growth of private securities markets and transactional forms that, however efficient, would not be open to the smaller investor and hence threaten a deterioration of the broad public markets.

My claim here is not that this message is wrong. It's risky, however. As negotiators know, a truly hard line, adversarial approach risks alienating the other side (securities professionals, institutions, and so forth), and these groups are not without political power of their own. It may provoke an overreaction when the political winds shift. But that is not the main point either. Rather, excessive faith in this one message makes it less likely that the Commission will succeed in some of the more subtle ideological and normative battles that it faces, including promoting managerial accountability in an atmosphere of scarce resources.

One example of this was raised earlier. Throughout the 1980s and 1990s, the courts redesigned the substantive antifraud protections in a way that was far from favorable to the individual investor. I suspect that the SEC abetted this in two respects. First, it left Rule 10b-5 untouched, allowing the courts the freedom to reinterpret it without authoritative agency guidance. The Commission remained wedded to an image—that it did not want to provide a blueprint for fraud and wanted the freedom to employ creative arguments for expanding its scope—that derived from a time when the courts were indeed the Commission's loyal allies.<sup>158</sup> Second, it remained committed for too long to an absolutist alliance with the private securities bar, identifying individual investor interests with vigorous class action litigation. This focus took away the Commission's ability to enter into a constructive dialog with the courts over ways to deal with their concerns about litigation excess in a way that would not threaten the substance of securities law enforcement. The courts, predictably, overreacted. The remnants of *Santa Fe* as an explicit critique of securities laws' role in agency cost reduction ought be vigorously and confidently countered on the merits, lest the courts persist in seeing—under the influence of rent-seekers on the other side—securities fraud enforcement as an outmoded form of old-style regulation.<sup>159</sup>

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158. The open-endedness of Rule 10b-5 is not an irrational thing for the SEC to try to preserve; losses can be recouped later on because of the flexibility of the rule. However, by continuing to hew to the standard lines it had always expressed, the Commission seemed to ignore the conservative forces that were, at least temporarily, pushing the law in the wrong way.

159. See Cox, *supra* note 134.

The judiciary is one audience to whom the SEC must learn to speak more persuasively, and the simple brand message will no longer do. Another audience, readily underestimated, is the business community. As we saw toward the end of this paper, compliance in a low-enforcement environment is a function of the perceived legitimacy of the legal rules in question. An “us versus them” message about the nature of securities regulation alienates “them”. Predictably, the investors’ champion message is reinterpreted within the business community as insensitivity to legitimate (if, perhaps, self-servingly interpreted) corporate needs. While the task of regulation inevitably provokes this sort of reaction, its intensity varies, and the presentation of the message can at least moderate it, especially among those not directly suspected of wrongdoing. Here, I will offer a critique of Regulation FD in terms of style, if not substance. At its core, the rule makes a great deal of economic sense. Selective disclosure has a skewing effect on markets and is plainly a form of insider trading, except possibly for the way the Supreme Court has designed the prevailing doctrine.<sup>160</sup> However, the breadth with which Regulation FD was drafted and its egalitarian rhetoric guaranteed a spiteful response from many in the business and legal communities. Without the resources to fight aggressively, the Commission has to be concerned with moral persuasion, and it should not confuse repetition of its historic brand message with something that resonates within the community of the regulated. It should not compromise on what is truly essential, but should be careful about the claims that it makes when it desires adherence.

Can the conventional brand message possibly be restyled? I would not abandon it entirely by any means: it has a history and an appeal. But it can and should be refurbished to incorporate some of the ideas from the recent renaissance of appreciation for securities regulation with which we began this Article. Securities regulation is a successful method for controlling agency costs: by exposing the “lemons” in the market basket via well-enforced disclosure requirements, it creates an environment in which both markets and the better issuers and managers can flourish.<sup>161</sup> It exists not as a populist mechanism to give investors more power as against managers collectively, but as a powerful way of separating the sweet corporate fruit from the sour.

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160. See Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023 (1990).

161. As one practical suggestion, I would use more carrots in place of sticks. For example, I would cap corporate damages for securities fraud upon a showing of a well-designed, well-implemented disclosure compliance system that was nonetheless frustrated by one or two corrupt managers—a regime not unlike the Organizational Sentencing Guidelines under federal criminal law—rather than seek penalties against the noncomplicit directors who, in hindsight, failed to monitor well enough. See Langevoort, *supra* note 10, at 57-58.

Without overstating the point, this version of what securities regulation is about—which has been heard from time to time, but far too softly—has the virtue of being both intellectually current and potentially resonant among a wider set of audiences.

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